CHARITABLE LEAD TRUSTS—A WIN-WIN STRATEGY FOR DONORS AND CHARITIES

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There is no doubt that the current economic environment has placed a significant strain on the fundraising efforts of charitable organizations. However, the current convergence of low interest rates and depressed property values provides charities with an unprecedented opportunity to educate donors about a planned giving technique that is tailor-made for the times. This technique is the charitable lead trust (CLT). Unlike many of the other techniques available for planned giving, a CLT puts funds in the hands of a charity now rather than later. In addition, it provides a guaranteed revenue stream on which the charity may rely as it plans for the future.

Although sometimes viewed as a relatively complex strategy, a CLT is nothing more than an irrevocable trust that splits the beneficial interest between a charitable beneficiary (or beneficiaries) and a noncharitable beneficiary (or beneficiaries). If properly structured, and under the right set of circumstances, a CLT can serve as the linchpin of an estate plan that accomplishes both a donor's family wealth transfer objectives and his or her charitable giving objectives. There is no better time than the present for charities to explain to donors the benefits of a CLT.

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The mechanics

The CLT is a straightforward estate planning strategy. It offers donors a method of moving wealth to children or other beneficiaries while furthering charitable goals. The donor simply transfers property to an irrevocable trust, and the terms of the trust agreement govern the manner in which the property is held and distributed.[1]

The terms of the irrevocable trust direct the trustees to make an annual distribution to one or more organizations that qualify as charitable organizations within the meaning of Section 501(c)(3). The annual distributions continue for a specified number of years or for the life of a named individual.[2] The trustees of the CLT may make the payments to the charity in cash or in kind.[3] The term of years during which the trustees make distributions to the charity is known as the "lead term." The provisions of the irrevocable trust further provide that, upon the expiration of the lead term, any property then remaining in the trust (i.e., the remainder interest) passes to specified noncharitable beneficiaries.[4]

The lead term is the charitable component of the trust, and the remainder interest is the noncharitable component. This splitting of the beneficiary interest into a charitable component and a noncharitable component is what causes a CLT to be known as a split-interest trust.

The annual payments made to charity may take the form of either a guaranteed annuity or a unitrust

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amount. An annuity is a fixed percentage of the fair market value of the property transferred to the trust as of the date of the transfer. A unitrust amount is a fixed percentage of the fair market value of the trust property as that value is re-determined annually during each year of the lead term. A CLT with terms that provide for annuity payments is known as a charitable lead annuity trust (CLAT).[5] A CLT with terms that provide for unitrust payments is known as a charitable lead unitrust (CLUT).[6]

A transfer to a CLT may be described as an appreciation play.

A CLT may be structured as an *inter vivos* CLT or a testamentary CLT. A trust that comes into existence during the lifetime of the individual who creates the trust is known as an *inter vivos* CLT. A trust whose terms are set forth in the last will and testament of the individual creating the trust and that does not come into existence until the death of such individual is known as a testamentary CLT.

The focus of a charity's planned giving presentation to donors should be on *inter vivos* CLTs rather than testamentary CLTs, because a CLT created under the terms of a donor's last will and testament may not come into existence for decades after the time of creation. Furthermore, a testamentary trust may not come into existence at all should the donor change his or her will prior to death. In contrast, an *inter vivos* CLT begins providing the charity with revenue on the first anniversary of its creation. Of course, charities should also be open to testamentary CLTs, which may be of greater interest to some donors, but such trusts cannot be relied upon to help address any immediate or near-term financial needs.

The economics

From an estate and gift tax perspective, a transfer to a CLT may be described as an appreciation play. If the value of the property transferred to the CLT appreciates significantly and/or its income yield is substantial during the "lead" term, the value of the property ultimately passing to the remainder beneficiaries will exceed the gift tax value of the remainder interest. To the extent the value of the property exceeds the gift tax value of the remainder interest, the grantor has transferred property to the noncharitable beneficiaries free of gift tax (or used less of the grantor's lifetime gift tax exclusion than would otherwise have been the case). As a corollary, any appreciation on the property received by the beneficiaries is removed from the donor's estate for estate tax purposes.

Accordingly, the property transferred to the CLT should be comprised of assets that meet one or more of the following criteria: (1) the asset is substantially undervalued due to market conditions, (2) the asset is ripe for a substantial "pop" in value (e.g., pre-IPO stock in a closely held company), and/or (3) the asset is highly likely to generate substantial cash flow in the near term. To understand how a CLT can be an effective appreciation play, one must understand the manner in which the gift tax value of the remainder interest is determined.

At the time the grantor transfers property to the CLT, the grantor is treated as having made a charitable gift equal to the present value of the stream of annuity or unitrust payments to be paid to the charity. The present value of this stream is determined by applying a discount rate to the aggregate payment to be made to the charity.

The rate used to discount the stream of payments to be made to charity back to the present is a rate that is equal to 120% of the federal mid-term rate in effect for the month during which the grantor makes the transfer to the CLT (or for either of the two months preceding the month in which the transfer occurs, whichever the grantor chooses). This rate is known as the Section 7520 rate. The lower the Section 7520 rate,

1 Relatively sophisticated donors who are familiar with grantor retained annuity trusts (GRATs) will recognize that the economics of a CLT mirror those of a GRAT, the difference being that it is a charity rather than the grantor who receives payments during the initial term of the trust.

2 The rule limiting the maximum term of a charitable remainder trust to 20 years does not apply to charitable lead trusts. However, a CLT must comply with the rule against perpetuities as formulated under the local law of the relevant jurisdiction.

3 The 5% minimum payout and 50% maximum payout rules applicable to charitable remainder trusts do not apply to CLTs.

4 The donor also may structure the CLT so that the trust assets revert back to him or her upon the expiration of the initial term. As the primary purpose of this article is to discuss the manner in which a CLT can accomplish a transfer of wealth to noncharitable beneficiaries as well as charitable beneficiaries, this option is not discussed further.

5 The IRS has provided sample CLAT forms. See Rev. Proc. 2007-45, 2007-29 IRB 89 (*inter vivos* CLAT); Rev. Proc. 2007-46, 2007-29 IRB 102 (testamentary CLAT).

6 The IRS has also provided sample CLUT forms. See Rev. Proc. 2008-45, 2008-30 IRB 224 (*inter vivos* CLUT); Rev. Proc. 2008-46, 2008-30 IRB 238 (testamentary CLUT).

7 Due to the fact that the amount of the unitrust payment to be made annually during the lead term is not determinable with absolute certainty, it is not possible to completely zero out a CLUT.

8 In addition, if the property transferred to the CLT is legitimately subject to valuation discounts (e.g., because it is a minority interest and/or is not readily marketable), the transfer to the CLT shelters not only future appreciation in the intrinsic value of the asset, but also the "appreciation" represented by the discount—that is, the difference between the intrinsic value and the fair market value.

the lower the rate at which the stream of payments is discounted. The lower the rate at which the stream of payments is discounted, the higher the present value of the revenue stream to be paid to charity.

At the time the grantor transfers property to the CLT, he or she also is treated as having made a noncharitable gift to the remainder beneficiaries. The gift tax value of the property transferred to the remainder beneficiaries is determined at the time the CLT is funded by subtracting the present value of the charity's revenue stream from the fair market value of the property transferred to the CLT. The higher the present value of the revenue stream to be paid to charity, the lower the present value—and therefore the gift tax value—of the remainder interest. The lower the gift tax value of the remainder interest, the greater the amount of trust property that can pass to the remainder beneficiaries free of gift tax.

Another way of stating this is that the remainder beneficiaries, on a gift tax-free basis, receive the upside of the economic performance of the trust assets over and above the Section 7520 rate. This is why the Section 7520 rate sometimes is referred to as the "hurdle" rate.

It is possible to structure a CLAT so that it is "zeroed-out" for gift tax purposes.[7] A CLAT is "zeroed-out" if the present value of the revenue stream to be paid to charity is equal to the fair market value of the property transferred to the trust. One may use any combination of payment amounts and lead term duration to set the present value of the charitable revenue stream at a value equal to the fair market value of the property transferred to the trust. In this situation, the present value of the remainder interest in the CLT—and therefore the gift tax value of the remainder interest—is necessarily zero. As a result, the grantor pays no gift tax (and uses up none of the grantor's lifetime gift tax exclusion) upon transferring the property to the trust.

At the time of this writing, the lifetime exemption from federal gift tax is $1 million, and the rate at which gift tax is levied on gifts over and above $1 million is 45%. Accordingly, a zeroed-out CLAT often is the preferred form of CLT, especially for the donor who already has used his or her lifetime gift tax exemption.

If the performance of the property transferred to the CLT is substantial enough, the value of the property passing to the remainder beneficiaries at the end of the lead term will exceed the total value of the property as of the date the grantor contributed it to the CLT.[8] This is particularly likely to be the case if, as is true in the current economic environment, a property's current fair market value is not a fair reflection of its inherent worth (assuming an eventual recovery of the property's value that may have been depressed by the economic downturn).

It is the win-win nature of the CLT that makes it a particularly appealing strategy for donors who wish to split the benefit of their wealth between charitable organizations and family members (or other noncharitable beneficiaries) in a highly transfer tax-efficient manner. For example, an individual who wishes to transfer $2 million worth of value to a charity certainly can write a check for $2 million. The present value of that gift is $2 million.

The difference between the outright gift and the CLT is the extent to which the remainder beneficiaries stand to benefit.

Assume, on the other hand, that the individual transfers $2 million worth of property to an *inter vivos* CLAT and sets the present value of the revenue stream passing to charity at $2 million (thereby zeroing out the CLAT for gift tax purposes). Just as with the outright gift, the charity is the beneficiary of property with a present value of $2 million.

It is noteworthy that the difference between the outright gift and the CLT is the extent to which the *remainder beneficiaries* stand to benefit. If the property outperforms the applicable hurdle rate, the remainder beneficiaries will receive some amount of property. The amount of property they will receive is directly proportional to the extent to which the property outperforms the hurdle rate. When, as is the case at the time of this writing, the Section 7520 rate is quite low (3.2%), the chances that the property will outperfom the hurdle rate are quite high.

Examples of transfers to *inter vivos* CLATs

Two examples show how these rules will apply in practice.

Example 1. Regarding the discussion above involving a transfer of $2 million worth of property to a zeroed-out CLAT, assume that Molly is a grantor who wishes to benefit her local animal rescue league and is committed to providing the league with $2 million worth of funding. In November 2009, when the Section 7520 rate is 3.2%, she creates a ten-year CLAT, transfers $2 million worth of cash-generating real estate to it, and names a trust for her six-year-old son as the remainder beneficiary. In order to zero out a ten-year CLAT using a Section 7520 rate of 3.2%, one must set the annuity payment to charity at $236,860.18. As a result, in November of each of the succeeding ten years, the animal rescue league will receive a payment of $236,860.18. When the lead term expires following the tenth payment in November 2019, any and all property remaining in the CLAT will pass into the trust for Molly's son, who will then be 16 years old.

The amount of property that will pass to the trust for Molly's son depends on the extent to which the real estate contributed to the CLAT grows during the lead term. Assume that over the course of the lead term the real estate both appreciates in value and produces income, for an overall increase of 8% in the value of the trust property. In that case, the amount of property that will pass to the trust for Molly's son—free of gift tax—is $886,560.20. Molly will have succeeded in providing her son with a substantial lifetime gift without paying any gift tax and without using any of her $1 million lifetime gift tax exemption.

Even if one assumes a more modest rate of return on the real estate, the CLAT provides significant benefits. If the overall growth in the value of property over the ten-year term is 6%, the amount passing on a gift tax-free basis to the trust for Molly's son will be $459,689.95. At 5%, the value of the remainder interest will be $278,587.36. It also is important to remember that any appreciation on the property passing to the remainder beneficiary is removed from the grantor's estate and accumulates for the benefit of the remainder beneficiary.

The extent to which CLTs are sensitive to interest rates becomes clear when one considers the results of establishing a ten-year CLAT funded with $2 million when the applicable Section 7520 rate is substantially higher, say 5%. In that case, in order to zero out the CLAT, the charity would have to receive an annual payment of $259,010.33. Assuming an 8% rate of return on trust property, the trust for the Molly's son would receive $565,680.80 (down from $886,560.20 where the Section 7520 rate is 3.2%). The trust for Molly's son would receive $167,733.46 if the rate of return was 6% and $0 if the rate of return was 5% (because the 5% rate of return is exactly equal to the Section 7520 rate).

Example 2. Assume that Harry is a young unmarried entrepreneur with no children. He wants to provide a local homeless shelter with $3 million to use in its efforts to expand the services it provides to the community. To provide the organization with a steady flow of revenue over the long term, he creates a 15-year zeroed-out CLAT and transfers to the CLAT a portfolio of securities hit hard by the recession. The applicable Section 7520 rate is 4.0%. As he does not plan to have children and expects to leave the bulk of his estate to his nieces and nephews, Harry names his nieces and nephews as the remainder beneficiaries of the CLAT.

Because the value of the securities as of the date of transfer is so depressed, the overall growth in the securities over the 15-year lead term is 10%. In this scenario, the amount of property passing to the remainder beneficiaries at the end of the lead term will greatly exceed the value of the property contributed to the CLAT. The homeless shelter will receive $242,298.70 per year for each of the succeeding 15 years. At the end of the 15-year term, $3,958,798.22 passes to Harry's nieces and nephews in equal shares. Although an overall 10% rate of return might not be realistic in normal circumstances, an overall 10% rebound following the stock market free fall of 2008 and 2009 is certainly possible.

Again, to demonstrate a CLAT's sensitivity to interest rates, if the transfer of $3 million did not occur until the applicable Section 7520 rate was 5.6%, the amount passing gift tax-free to the remainder beneficiaries at the end of the 15-year term would fall from $3,958,798.22 to $2,972,469.46. Although certainly not a bad result—and even a better result from the homeless shelter's perspective (due to the fact that it would receive $300,866.49 rather than $242,298.70 each year), the current lower Section 7520 rate substantially enhances the wealth transfer potential of the zeroed-out CLAT.

Income tax consequences

The income tax consequences to the grantor of a CLT depend on whether the CLT is structured as a grantor trust or a nongrantor trust during the lead term. A grantor trust is a trust that is treated as owned by the grantor. As a result, all of the CLT's income, deductions, losses, and credits flow through to the grantor, and the trust is disregarded for income tax purposes. A nongrantor trust is a trust treated as a separate taxpayer for income tax purposes. As a result, it reports all income, deductions, losses, and credits on its own trust income tax return.

[9] The grantor's ability to use this deduction, like all charitable deductions, is subject to certain limitations that are based on the grantor's adjusted gross income for the year of the transfer.

When a grantor's primary goal in establishing a CLT is transferring property to the remainder beneficiaries in a transfer tax-efficient manner, the CLT generally should be structured as a nongrantor CLT. The reason a nongrantor CLT is preferable in this situation is that, in order to obtain grantor trust status for a CLT, the grantor retains certain beneficial interests in or powers over the trust. The retention of such interests or powers runs the risk of causing the value of the trust assets to be included in the grantor's estate under the federal estate tax. Such inclusion would defeat the grantor's goal of reducing or avoiding federal estate and gift tax on the transfer of the property.

The grantor of a nongrantor CLT is not taxed on the CLT's income and is not entitled to a charitable income tax deduction when he or she transfers property to the CLT. Instead, the CLT itself is subject to tax on its income, but it receives a charitable income tax deduction to the extent the income is paid to the charitable beneficiary.

In contrast, the grantor of a CLT that is treated as a grantor trust for income tax purposes receives an immediate charitable income tax deduction equal to the present value of the lead interest.[9] Going forward, the grantor must report any income, loss, deduction, or credit attributable to the CLT on his or her personal income tax return (even though the income, for example, remains in the CLT and so is not available to the grantor for purposes of paying the tax).

Conclusion

A CLT (and in particular a zeroed-out *inter vivos* CLAT) is a planned giving strategy that is extremely well suited to the current economic environment. To be sure, the strategy should be employed only by those potential donors who are committed to charitable giving and who have substantial income-producing property over and above the property transferred to the CLT. For those who meet those criteria and who wish to have a coordinated estate plan designed to benefit both charitable and non-charitable beneficiaries, a CLT is a quintessential win-win strategy and an ideal planned giving vehicle for charities to present to current and potential donors.